DNR Capital Australian Equities High Conviction Fund

Performance Report – July 2021

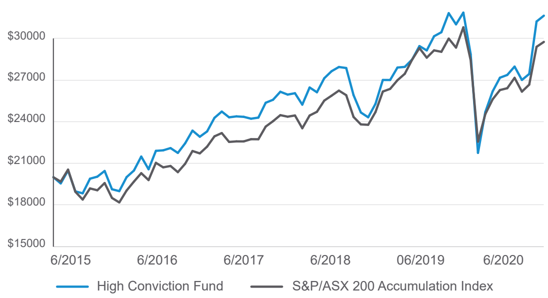
Performance

The S&P/ASX 200 Accumulation Index was up 1.10% during the period.

Materials (+7.1%) was the best performing sector. In a reversal from last month, sentiment swayed back towards the inflationary argument, with commodities prices continuing their ascent. Industrials (+4.3%) also outperformed in the pro-cyclical rally, however it was largely due to the takeover offer for Sydney Airport Holdings (SYD, +34.9%). Information Technology (-6.9%) was the worst performing sector following its rally last month. Energy (-2.5%) also underperformed, despite a higher oil price and a weaker Australian Dollar as company specific issues drag on the domestic names versus overseas peers.

DNR Capital Australian Equities High Conviction Fund underperformed its benchmark for the period. Key stock contributors were BHP Group (BHP), Westpac Banking Corporation (WBC, no holding) and Afterpay (APT, no holding). Key stock detractors were SEEK (SEK), Computershare (CPU) and Qube Holdings (QUB).

Growth of $20,000 since inception



Source: Mainstream Fund Services and DNR Capital

Top 10 active holdings

Security details	Active weight %	Actual weight %
Tabcorp Holdings	4.47	5.01
Lendlease	4.26	4.66
Macquarie Group	3.92	6.49
National Australia Bank	3.83	7.93
BHP Billiton	3.64	11.21
Aristocrat Leisure	3.26	4.55
Telstra Corporation	3.05	5.21
Suncorp Group	2.98	3.70
Computershare	2.92	3.35
SEEK	2.86	3.37

Source: Mainstream Fund Services and DNR Capital

Fund overview

APIR Code	PIM0028AU
Investment bias	Style neutral with a quality focus
Designed for	Investors seeking a medium-term investment focused on achieving growth, with less focus on generating excess income. The investor is prepared to accept higher volatility in pursuit of higher growth.
Investment objective	To invest in a high conviction portfolio of Australian equities that aims to outperform the Benchmark by 4% p.a. (before fees) over a rolling three-year period. The investment objective is not a forecast of the Fund's performance.
Benchmark	S&P/ASX 200 Accumulation Index
Investable universe	Australian equities and cash
Investment constraints	The Fund will not invest in derivatives.
Investment guidelines	Maximum exposure to an individual security is 15% of Fund NAV Minimum exposure of 80% of the Fund NAV to be invested in the S&P/ASX 200
Asset allocation	Australian Equities – 80-100% Cash – 0-20%
Risk level	High
Number of securities	Min 15 - max 30, typically 25
Minimum suggested investment timeframe	5 years
Buy/sell spread	+0.25% / -0.25%
Management fee	0.90% (inclusive GST and RITC)
Minimum initial application amount	$20,000
Minimum further application amount	$5,000
Minimum withdrawal amount	$5,000
Valuation and unit pricing frequency	Each business day
Distribution frequency	Semi-annual
Responsible entity	The Trust Company (RE Services) Limited as part of the Perpetual Limited group of companies
Entry/exit fees	Nil

Net active return as at 31 July 2021

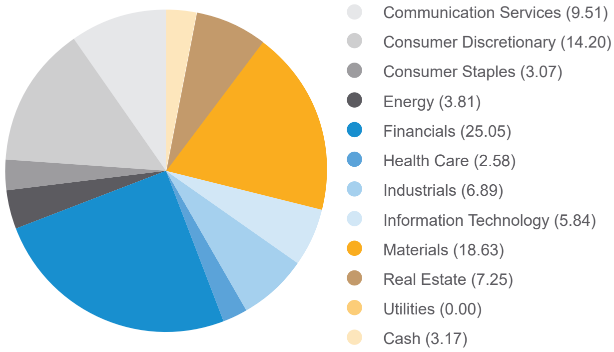
	1mth	3mth	6mth	1yr	3yr	5yr	Incep.*
High Conviction Fund	-0.10	4.94	16.89	34.91	10.14	11.01	10.50
S&P/ASX 200 Accumulation Index	1.10	5.80	13.78	28.56	9.48	10.05	9.00
Excess return	**-1.20**	**-0.86**	**3.11**	**6.35**	**0.66**	**0.96**	**1.50**

** Inception Date—June 2015*

Source: Mainstream Fund Services and DNR Capital

Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry fees or taxation.

Sector weightings %



Source: Mainstream Fund Services and DNR Capital

Attribution

The top stock contributors for the month were:

- **BHP Group** (BHP): Performed strongly with the iron ore price holding above $200 US/t. Production results were largely in line with expectations and current pricing supports a strong dividend outlook.
- **Westpac Banking Corporation** (WBC, No Holding): Banks drifted as Sydney moved into lockdown and post paying a dividend in June.
- **Afterpay** (APT, No Holding): Underperformed during the month as product announcements by Apple and Paypal raised concerns about growing competition amongst BNPL operators. Whilst we have viewed the valuation of APT as stretched, a subsequent takeover offer by Square, Inc has seen the group trade at a premium that is likely to persist until completion.

The top stock detractors for the month were:

- **SEEK** (SEK): Underperformed during the month in line with other online classified names impacted by lockdowns. Tailwinds from an economic recovery and a re-architecting of pricing structures position the group well in the medium to long term.
- **Computershare** (CPU): Drifted as bond yields pulled back and delays to the end of mortgage foreclosure amnesty which limits profitability on CPU's mortgage servicing business.
- **Qube Holdings** (QUB): QUB announced it had entered into binding commercial terms with LOGOS for the sale of 100% of its interest in the warehousing and property components of Moorebank. Despite this positive announcement, the market is concerned with the outlook for economic activity. Whilst QUB has cyclical exposures, it has been the beneficiary of tailwinds across a number of its businesses including port volumes, mining, agriculture and forestry products and remain exposed into a recovery scenario.

Market review

This month we discuss the global outlook as well as the outlook for reporting season. Following a volatile 18 months where we have plunged into lockdown, bounced strongly as we reopened and enjoyed fiscal stimulus doubts have crept into the market thanks to the Delta strain and the fact we are cycling very low levels of economic activity, it is difficult to judge the strength of the recovery. We consider these factors.

Global outlook

Only a few months ago the market was focused on the upside risks to growth and inflation, driven by the combination of loose monetary policy, aggressive fiscal stimulus and accelerating vaccine rollout. This appears to have changed, with the partial unwind of the reflation trade over the last three months. The main sector-level beneficiaries of reflation (energy, materials, and financials), have all under performed, even as markets continue to rally.

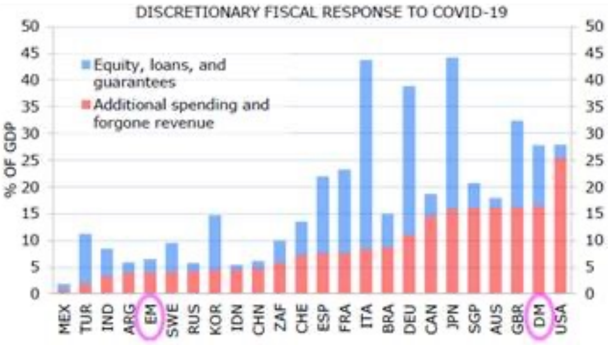
The reflation trade started to reverse from May

Source: MSCI, Minack Advisors

Investors are now focused on the downside risks to growth. There is no question that growth is at an inflection point, the June quarter growth rates (off a very low base) cannot be sustained. However the market is pricing a slowdown, not a downturn. The extent to which US President Biden's infrastructure program can be implemented, further progress on vaccine rollout and opening up will play a factor in the strength of the economic outlook.

The US has been at the forefront on both stimulus and vaccination, so its recovery has been strong relative to history and also to other major regions. Europe has recently caught up, with vaccinations strengthening its recovery. Two factors have been important to the speed of the country-level rebound. The first was the size of the fiscal response, which was much larger in developed than emerging economies.

Strong fiscal stimulus in DM led by the US

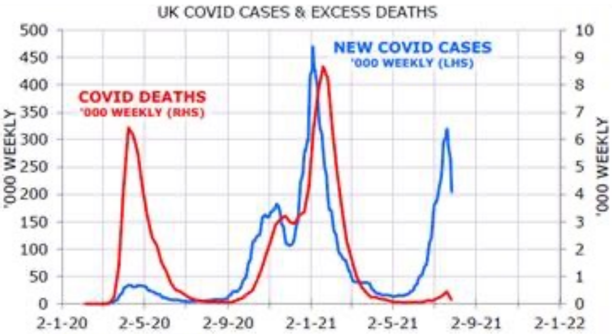


Source: IMF, Minack Advisors

Then there has been the vaccine rollout, with developed markets again leading emerging markets.

The Delta strain is the largest downside risk. However, if the UK experience is any guide, then it seems likely that the underlying growth trajectory remains intact. Demonstrated from UK data in the following chart, the vaccine rollout is muting the health damage of rising infection rates.

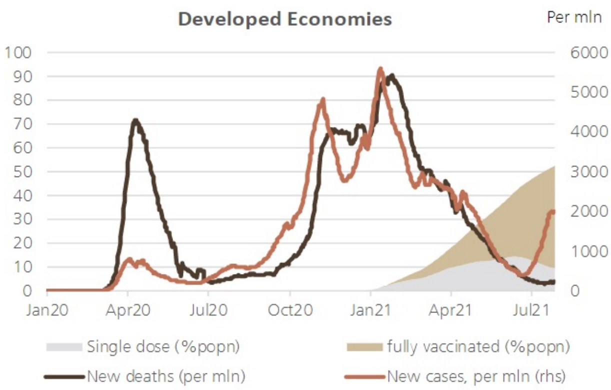
UK infections less dangerous after vaccination



Source: Our World In Data, Minack Advisors

This can also be seen in the chart below which highlights the reduction in deaths in developed countries as vaccination rates rise despite increasing case numbers.

Cases, deaths and vaccine progress



Source: UBS, Our World In Data

The outlook has also been clouded by uncertainty regarding the US Federal Reserve (the Fed) response to inflation. Inflation expectations remain high but the market appears reasonably relaxed assuming the inflation is either transitory (meaning it will ease as supply side constraints are eased) or the Fed will step in causing the economy to slow.

The decline in long-end yields reflects this. Real rates are negative and inflation expectations are elevated. Some of the factors that have driven deflation in the past few decades remain including:

1. Technology disruption reducing wage pressure
2. Ageing population
3. Excess debt

However the politics has changed:

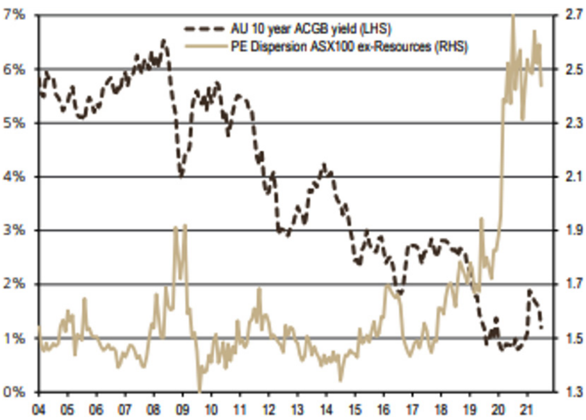
1. Geopolitical stresses means the trend towards outsourcing to China is easing and post COVID-19 we expect this change to remain.
2. ESG concerns means a focus on modern slavery and a focus on environmental costs which drives up cost.
3. Governments are less restrained by a focus on budgetary restraint. We believe the expansion will continue until there is a policy response and that will not come until we see inflation.

Market's inflation expectations remain high

Source: Bloomberg, ISM, NBER; Minack Advisors

Price to earnings (PE) dispersion remains extreme, driven by low interest rates, scarcity of growth and/or growth concerns. However, policy makers remain keen to drive growth and policy settings remain loose. So long as pandemic disruptions are short-lived (like the UK experience) then above-trend growth is more likely, which points to a renewed rise in long-end yields.

PE dispersion

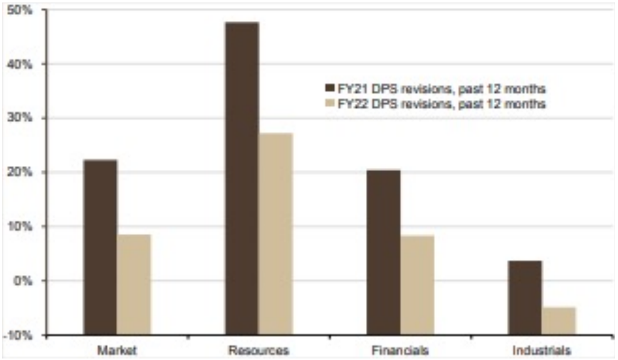


Source: IBES, UBS

Upbeat reporting season expected

After a collapse of >30% in earnings per share (EPS) in FY20, market consensus expects ASX100 FY21 EPS to rebound by almost 50% in FY21. This has been driven by record commodity prices, booming house prices and elevated consumption driven by very loose monetary and fiscal stimulus. Dividend expectations have also been raised.

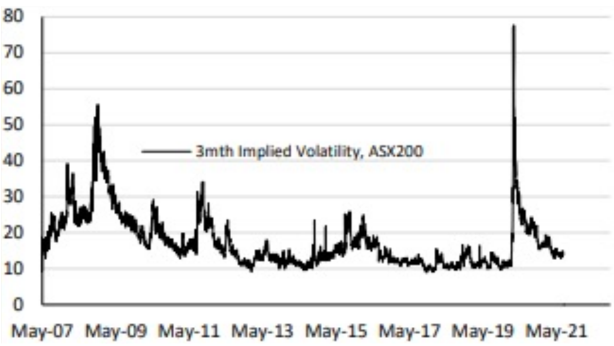
Dividend per share (DPS) revision upgrades



Source: FactSet, UBS

The pre-reporting 'Confession season' delivered more upgrades than downgrades and implied that volatility has fallen sharply over the past six months, suggesting markets are pricing an upbeat outlook for reporting season. We think the risk will be more around outlook statements given the uncertainty as we look into FY22. How long will we stay in lockdown? How strong will the economy be as we cycle from a period of strong fiscal stimulus?

ASX200 volatility



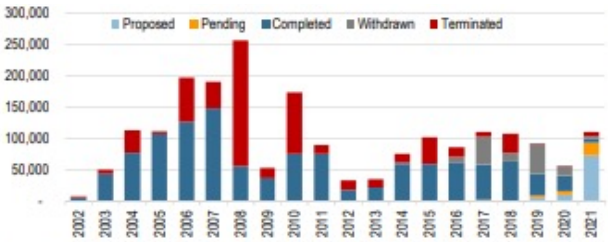
Source: Bloomberg, UBS

EPS growth of almost ~10% is expected into FY22, however the current lockdown in Australia will deliver a hit of >$20b and increases uncertainty. This may also reduce confidence in board and management to provide meaningful outlook commentary.

Corporate activity

Capital preservation has turned to corporate activity as confidence returns and the economy recovers. M&A has surged with aggregate deal flow already marking a 10-year high. With leverage net debt/earnings before interest taxes depreciation and amortisation (ND/EBITDA) falling by 0.5x, the majority of companies are operating with decade-low leverage ratios. As such, there is substantial capacity for more M&A, even before considering private equity and large super funds.

Annual deal value (ASX200)*



Source: J.P. Morgan estimates, Bloomberg Finance L.P.
** Deal data sourced from Bloomberg Finance L.P. and includes all transactions (asset & corporate) within the ASX 200.*

ND/EBITDA ratio track (2008-current)

Source: J.P. Morgan estimates, Bloomberg Finance L.P.

Some recent examples below:

Cash flow appeal: Sydney Airport Holdings (SYD) bid; Qube Holdings (QUB) sale of Moorebank; Spark Infrastructure (SKI) bid.

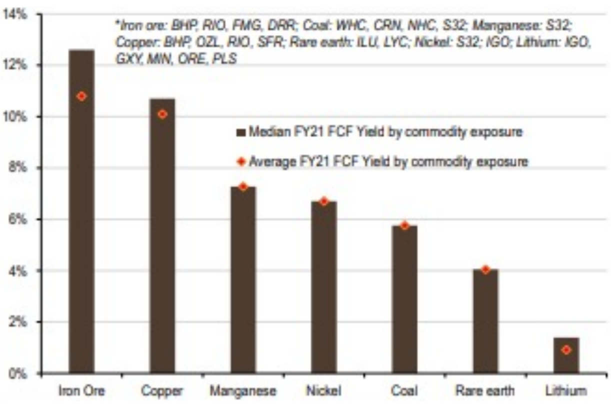
Scale / Enhancing core: Stockland Corporation (SGP) / Halcyon acquisition; Santos (STO) / Oil Search (OSH) proposed merger; Star Entertainment Group (SGR) / Crown Resorts (CWN) proposed merger; Computershare (CPU) / Wells Fargo acquisition.

Demergers: AGL Energy (AGL) demerger; Woolworths Group (WOW) / Endeavour Group (EDV) demerger.

Attractive mining dividend yields

Dividend yields in mining stocks are attractive. This has been driven by record commodity prices. At current prices, iron ore and copper miners are trading at elevated cash flow yields of >10%.

Miner free cash flow yields



Source: FactSet, UBS

Commodity prices are clearly cyclical and are not expected to remain at current levels (in particular iron ore), however consensus expects a material decline in earnings beyond FY21.

With the global recovery underway and the push toward renewable technology investment, it is possible that prices will remain above market expectations for longer.

Improving areas of the market

We will also be looking for confirmation that sectors like Telecommunications and general insurance are seeing progress regarding improved profitability, improving pricing and cost control.

Fund positioning

Our current positioning is:

1. **Reopening beneficiaries**: SKYCITY Entertainment Group (SKC).
2. **Beneficiaries of infrastructure/green new-deal spending**: ALS (ALQ), QUBE Holdings (QUB).
3. **Improving quality**: Computershare (CPU).
4. **Strong franchise companies**: James Hardie Industries (JHX), SEEK (SEK), Aristocrat Leisure (ALL).
5. **Resilient/defensive companies**: Tabcorp Holdings (TAH).

Key risks

Key risks to the Fund include:

- **COVID-19 disruption.** The longer and deeper the disruption from the COVID-19 pandemic, the greater the negative impact on equity markets. Any disruption to the roll out of the vaccines would be negative, as would the development of vaccine-resistant COVID-19 variants.
- **Interest rates.** Low interest rates are the prime driver of markets at present. Any change to the inflation outlook would have a significant impact on valuations.
- **Political environment.** Further geopolitical uncertainty including civic destabilisation in the US and regional tensions with China could create negative implications for stocks and portfolios.

Portfolio moves

Sale of REA Group (REA)

We have recently exited REA. Record low interest rates and skyrocketing house prices saw listings grow to levels not seen in several years. Given realestate.com.au's dominant market position, flexible cost base and strong balance sheet, we believe the group is well positioned for continued improvement in the housing market. Valuation is full however, and we have redeployed into other opportunities.

Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when it is combined with a thorough valuation overlay. We seek to identify quality businesses that are mispriced by overlaying a quality filter, referred to as the 'quality web', with a strong valuation discipline. The portfolio is high conviction and invests for the medium term.

Investment strategy

The DNR Capital Australian Equities High Conviction Fund has an investment style best described as 'style neutral'. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices. We define quality businesses as being those with the following five attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk.

Where we are satisfied that a company possesses quality characteristics, then it is eligible for inclusion in the Fund. However, it must also represent value and sit comfortably within our portfolio construction requirements.

A range of valuation methodologies are used depending on the nature of the company being assessed to identify mispriced opportunities.

The portfolio construction process is influenced by a macroeconomic appraisal and also considers the risk characteristics of the portfolio, such as stock and sector correlations.

Platform access

- Asgard
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- My North & North
- Netwealth
- Wealth O2

Office address
Level 23
307 Queen Street
Brisbane QLD 4000

Postal address
GPO Box 3263
Brisbane QLD 4001

Telephone
07 3229 5531

Email
info@dnrcapital.com.au

Website
www.dnrcapital.com.au